

No. 15,726

**In the United States Court of Appeals
for the Ninth Circuit**

ALBERT J. FIHE AND ELIZABETH FIHE, PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

*ON PETITION FOR REVIEW OF THE DECISIONS OF THE TAX
COURT OF THE UNITED STATES*

BRIEF AND APPENDICES FOR THE RESPONDENT

CHARLES K. RICE,
Assistant Attorney General.

LEE A. JACKSON,
MELVA M. GRANEY,
KARL SCHMEIDLER,
Attorneys,
Department of Justice,
Washington 25, D. C.

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The Tax Court was correct in upholding the Commissioner's determination that there were deficiencies in taxpayers' reported incomes for 1946, 1947, and 1948, and that at least part of these deficiencies was due to negligence, so that taxpayers were liable for the 5% addition to tax for each of these years under Section 293(a) of the Internal Revenue Code of 1939.....	22
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OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 47-73) are not officially reported.

JURISDICTION

This petition for review (R. 76-79) involves federal income taxes for the taxable years 1946, 1947, 1948 and 1949. On January 14, 1954, the Commissioner of Internal Revenue mailed to taxpayers notices of deficiencies in the total amount of \$16,839.16 and of 5% negligence penalties in the total amount of \$1,355.87. (R. 7-11, 18-29.) Within ninety days thereafter, on April 8, 1954, taxpayers filed petitions with

the Tax Court for a redetermination of those deficiencies under the provisions of Section 272 of the Internal Revenue Code of 1939. (R. 3-29.) The decisions of the Tax Court were entered April 30, 1957, (R. 73-75.) The case is brought to this Court by a petition for review filed July 29, 1957. (R. 76-79.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTIONS PRESENTED

1. Whether the Tax Court was correct in upholding the Commissioner's determination that taxpayers understated their business income for each of the years 1946 through 1949 and claimed excess itemized deductions for the years 1947 through 1949.

2. Whether the Tax Court was correct in upholding the Commissioner's determination that taxpayers understated income received by them from Holly Molding Devices, Inc., for the years 1947 and 1948.

3. Whether the Tax Court was correct in upholding the Commissioner's determination that taxpayers understated long-term capital gain received by them in 1948 from the sale of their stock in Holly Molding Devices, Inc.

4. Whether the Tax Court was correct in upholding the Commissioner's determination that part of taxpayers' deficiencies for 1946, 1947 and 1948 was due to negligence, and that taxpayers were liable for the 5% addition to tax for each of these years under Section 293(a) of the Internal Revenue Code of 1939.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions are set forth in Appendix A, *infra*.

STATEMENT

The relevant facts as found by the Tax Court (R. 48-52, 55-61, 65-68, 72) may be summarized as follows:

Taxpayers are husband and wife. The taxpayer-husband filed a separate return for 1946, and both taxpayers filed joint returns for 1947, 1948 and 1949.¹ The taxpayer is a practicing attorney specializing in patent law for some thirty-four years. He maintained an office in Chicago for that length of time, closing it in 1948. He has had an office in Los Angeles, California, for thirty years. Taxpayer and his wife, Elizabeth, moved from Chicago to California in 1948. (R. 48.)

In 1936 taxpayer and his wife formed a partnership, known as Holly Molding Devices, with Harry Holly and Holly's wife. The partnership engaged in the manufacture and sale of hamburger molds. Holly was the inventor of the device, and taxpayer furnished his services in procuring the patent. Elizabeth was a member of the partnership in 1946, having a one-fourth interest therein. (R. 48-49.)

After taxpayer and his wife moved to California in 1948, taxpayer engaged in the practice of patent law and the manufacture and sale of fishing equipment. (R. 49.)

Issue No. 1

The Commissioner determined that taxpayer understated his business income for each of the years 1946, 1947, 1948 and 1949. The Commissioner also disallowed certain itemized deductions claimed by taxpayers for the years 1948 and 1949. (R. 49-51.)

¹ Whenever the term "taxpayer" is used in this brief it is intended to refer to Albert J. Fihe, taxpayer-husband; whenever the term "taxpayers" is used, it is intended to refer to Albert J. Fihe and his wife, Elizabeth M. Fihe.

With respect to 1946 the Commissioner determined that taxpayer understated his business income by \$5,015.58 as follows (R. 49):

Expense	Claimed	Allowed	Disallowed
(1) Litigation Expense.....	\$5,720.30	\$4,720.30	\$1,000.00
(2) Travel expense.....	4,763.77	3,226.30	1,537.47
Total disallowed expenses.....			\$2,537.47
(3) Unreported income—Los Angeles office.....			749.69
Total.....			\$3,287.16
(4) Loss, Los Angeles office, claimed on amended return, disallowed.....			(1,728.42)
Adjustment—increase in business income.....			<u>\$5,015.58</u>

For 1947 the Commissioner determined that taxpayer had understated his business income by \$5,546.17 as follows (R. 49):

Expense	Claimed	Allowed	Disallowed
(1) Legal.....	\$4,269.26	\$1,669.26	\$2,600.00
(2) Travel.....	5,881.56	4,433.61	1,447.95
(3) Advertising.....	1,042.97	487.97	555.00
Total disallowed expenses.....			\$4,602.95
(4) Gross receipts understated.....			943.22
Adjustment—increase in business income.....			<u>\$5,546.17</u>

The \$2,600 of legal expenses which the Commissioner disallowed represented the payment by taxpayer of legal fees for Harry Holly in connection with the defense of a criminal action against Holly. (R.49.)

The Commissioner adjusted taxpayer's 1947 income in taxpayer's favor by allowing a net operating loss carry back from 1949, as follows (R. 50):

Business income (loss) per return.....	(\$3,151.10)
Increase per above adjustment.....	5,546.17
Business income as adjusted.....	<u>\$2,395.07</u>
Less:	
Net operating loss from 1949 allowed.....	20,761.06
Business income (loss) as adjusted.....	(18,365.99)
Business loss claimed on return.....	(3,151.10)
Adjustment—decrease in net income.....	<u>\$15,214.89</u>

The Commissioner also disallowed certain itemized deductions claimed by taxpayer for 1947, as follows (R. 50):

Deductions	Claimed	Allowed	Disallowed
(1) Contributions.....	\$ 448.15	\$ 356.15	\$ 92.00
(2) Taxes.....	7,680.88	1,397.50	6,283.38
(3) Medical—Disallowed because of percentage limitation			

The amount disallowed for taxes included federal income and other federal taxes, such as transportation, amusement and “Pullman” taxes. (R. 52.)

For 1948 the Commissioner determined that taxpayer understated his business income by \$16,387.10, as follows (R. 50-51):

Expense	Claimed	Allowed	Disallowed
(1) Interest.....	\$3,111.84	\$2,876.44	\$ 235.40
(2) Taxes.....	2,600.84	2,089.55	511.29
(3) Losses.....	3,362.44	0	3,362.44
(4) Freight.....	1,630.41	505.96	1,124.45
(5) Legal.....	3,326.14	2,764.39	561.75
(6) Stationery.....	2,794.47	2,644.47	150.00
(7) Travel.....	8,679.14	2,876.17	5,802.97
(8) Commissions.....	1,426.30	626.30	800.00
(9) Advertising.....	3,483.94	2,885.80	598.14
(10) Repairs.....	535.33	460.76	74.57
(11) Postage.....	732.18	488.85	243.33
(12) Phone & Telegraph.....	1,323.41	1,251.88	71.53
(13) Depreciation.....	2,755.11	773.53	1,986.58
Total Disallowed expenses.....			\$15,522.45
(14) Add: Error in addition of deductions on return.....			584.20
(15) Unreported Receipts.....			280.45
Adjustment—increase in business income.....			<u>\$16,387.10</u>
Business income (loss) per return.....			(\$33,363.88)
Increase per above adjustment.....			<u>16,387.10</u>
Business income (loss) as adjusted.....			<u>(\$16,976.78)</u>

The amounts claimed as business expenses for freight and travel expenses included the cost of moving taxpayers’ personal possessions from Chicago to California and the cost of maintaining the family in a hotel until a new home was established. Taxpayer also deducted automobile expenses which included the cost of travel to and from work. He also deducted the cost

of new suits as advertising expenses and testified in that connection, "If I do not look pretty prosperous, I do not get patent business," and "I think it is perfectly good advertising and the only way a lawyer can advertise." (R. 52.) The Commissioner disallowed these amounts.

For 1948 the Commissioner also disallowed certain itemized deductions claimed by taxpayer, as follows (R. 51):

Deductions	Claimed	Allowed	Disallowed
(1) Contributions.....	\$ 664.48	\$ 291.25	\$ 373.23
(2) Casualty loss.....	2,300.04	0	2,300.04
(3) Medical.....	1,089.34	735.79	Percentage limitation

The casualty loss of \$2,300.04 claimed by taxpayer was asserted to be for "Damaged and stolen furniture and stolen wallet." Of this amount \$214 represented cash which, according to taxpayer's records, was stolen from a wallet, and the remainder represented the cost of purchasing new furniture to replace furniture which taxpayer claimed was lost, stolen and damaged in the move to California. (R. 52.)

The year 1949 is here involved to the following extent: As shown in Issue No. 3, *infra*, the Commissioner contended, and the Tax Court agreed, that the sale of taxpayers' stock in the Holly corporation took place in 1948 and not in 1949. Accordingly, taxpayer's 1949 income was reduced and the reduction resulted in a net operating loss for that year which was carried back to 1947. (R. 27-29.) The Commissioner, however, made other adjustments to taxpayer's 1949 reported income, in the total amount of \$10,602.38, as follows (R. 51):

	Expense	Claimed	Allowed	Disallowed
(1)	Repair.....	\$2,517.15	\$ 407.13	\$ 2,110.02
(2)	Advertising.....	3,658.25	976.59	2,681.66
(3)	Litigation.....	1,042.22	794.82	247.40
(4)	Travel.....	4,476.41	2,493.24	1,983.17
(5)	Interest.....	3,909.95	3,308.89	601.06
(6)	Postage.....	720.32	471.32	249.00
(7)	Depreciation.....	2,550.40	1,843.23	707.17
(8)	Telecast expense.....			1,661.62
(9)	Bandmaster.....			632.50
	Total disallowed expenses.....			\$10,873.60
(10)	Receipts understated.....			628.78
	Total.....			\$11,502.38
	Less: Mathematical error.....			900.00
	Net increase in business income.....			\$10,602.38

The Commissioner also disallowed certain of the itemized deductions claimed in 1949 by taxpayer, as follows (R. 51):

	Deductions	Claimed	Allowed	Disallowed
(1)	Contributions.....	\$ 285.51	\$47.51	\$ 238.00
(2)	Interest.....	3,909.95	-0-	3,909.95
(3)	Taxes.....	3,511.44	-0-	3,511.44

The Tax Court sustained *in toto* the above adjustments made by the Commissioner for 1946, 1947, 1948 and 1949. (R. 52-55.)

Issue No. 2

On or about September 25, 1946, taxpayer and the Hollys formed a corporation known as Holly Molding Devices, Inc., the name of which was later changed to Hollymatic Corporation (hereafter called the corporation) to carry on the business formerly carried on by the former partnership, Holly Molding Devices. With the exception of certain improved real estate which was distributed to the former partners, all the assets and liabilities of the partnership were turned over to the corporation in exchange for capital stock to be issued to the former partners. The real estate was rented to the corporation for a time by the former partners. (R. 55.)

Taxpayer was named president of the corporation and his wife was named treasurer. During 1946 and 1947 taxpayer was in charge of the corporation's books and records. In 1947 he employed a firm of certified public accountants to audit the books. (R. 55.)

Both taxpayer and his wife had authority to draw checks on the corporation provided such checks were countersigned by either Harry Holly or his wife. Prior to the sale by taxpayer and his wife of their stock in the corporation, corporate checks issued by Holly or his wife were required to be countersigned by one of the taxpayers. (R. 55-56.)

For 1947 the corporation's books and records reflect that credits were made to the personal account of taxpayer and his wife in the corporation in the respective amounts of \$23,998.74 and \$1,175, that disbursements were made by checks by the corporation to taxpayer and his wife in the amount of \$36,523.99, and that debits were made to the personal accounts of taxpayer and his wife in the respective amounts of \$7,305.22 and \$1,410.04 (R. 56-61.) These items are as follows:

For 1947 the corporation's books and records reflect salary paid or credited to taxpayer of \$25,920. According to these books and records \$14,000 of salary, less withholding of \$2,476.90, or a net amount of \$11,523.10 was paid to taxpayer, and \$10,706.20 of salary was credited to his personal account. (R. 56.)

The \$23,998.74 of credits made to taxpayer's personal account in the corporation are as follows (R. 56-57):

\$ 724.18	Loan to corp.
10,706.20	Accrued salary
140.00	Accrued rent
5,123.03	Patent Installment payments (later reversed)
6,227.21	Patent Installment payments
100.00	Rent
918.12	Minimum on royalties
60.00	Accrued Rent

The \$1,175 of credits made to the personal account of taxpayer's wife in the corporation are as follows (R. 57):

\$875	to correct advances
140	accrued rent
100	accrued rent
60	accrued rent

As to the \$36,523.99 of disbursements made by the corporation in 1947 to taxpayer and his wife, the corporate books and records and/or the personal records maintained by taxpayer reflect the following amounts (R. 59):

1/10/47.....	\$ 1,000.00	
1/10/47.....	800.00	
3/17/47.....	800.00	
3/21/47.....	550.00	
4/30/47.....	3,000.00	
4/30/47.....	1,000.00	(Reflected as \$700 debit to petitioner and \$300 debit to Elizabeth; Reflected as one receipt on petitioner's personal records)
4/30/47.....	700.00	
4/30/47.....	2,325.00	
5/31/47.....	2,600.00	
6/30/47.....	2.94	
6/30/47.....	3,632.05	
6/30/47.....	408.54	
9/30/47.....	5,890.00	
12/ 5/47.....	2,292.36	
Add.....	11,523.10	(Representing amounts disbursed by check, roughly net of withholding tax, as per corporate records, and petitioner's personal records)

Total.....\$36,523.99

(Note: Above total does not include the \$1,000 option payment of December 13, 1947, hereafter referred to.)

An examination of these disbursements reveals the following: The corporation books and records reflect disbursements by check of \$1,000 to taxpayer and \$800 to his wife on January 10, 1947. These disbursements were debited to their personal accounts. The personal records maintained by taxpayer reflect receipt of this \$1,800 amount on January 11, 1947. (R. 57.)

The corporation books and records reflect a disbursement by check on March 17, 1947, of \$800 debited to the personal account of taxpayer. The personal records maintained by taxpayer reflect a cash receipt of \$800 from the corporation on March 15, 1947. (R. 57.)

The corporation books and records reflect a disbursement by check of \$3,000 to taxpayer which was debited to his personal account on April 30, 1947. The personal records maintained by taxpayer reflect a cash receipt of \$3,000 from the corporation on April 22, 1947. (R. 57.)

The corporation books and records reflect a disbursement by check on April 3, 1947, of \$1,000 which was allocated \$700 to taxpayer and \$300 to his wife and debited in such amounts to their personal accounts on April 30, 1947. The personal records maintained by taxpayer reflect a cash receipt of \$1,000 from the corporation on April 1, 1947. (R. 57-58.)

The corporation books and records reflect two additional disbursements by check of \$700 and \$2,325 in April which were debited to the personal account of taxpayer on April 30, 1947. The personal records maintained by taxpayer reflect cash receipts from the corporation of \$700 on April 17, 1947, and \$2,325 on April 26, 1947. (R. 58.)

The corporation books and records reflect that salary in the amount of \$14,000 was disbursed by checks to taxpayer in 1947. The personal records maintained by taxpayer reflect cash receipts of salary in the total amount of \$11,523.10. These are net amounts and do

not reflect withholding for income and social security taxes. (R. 58.)

The corporation books and records reflect a disbursement by check to taxpayer on June 20, 1947, of \$3,632.05 which was debited to his personal account on June 30, 1947. The personal records maintained by taxpayer reflect a cash receipt of \$3,632.05 from the corporation on June 25, 1947. (R. 58.)

The corporation books and records reflect a disbursement by check to taxpayer on May 13, 1947, of \$2,600 which was debited to his personal account on May 31, 1947. This check was issued to pay legal fees for Harry Holly pursuant to an agreement with taxpayer and the personal records maintained by taxpayer do not reflect this amount as a receipt of income. (R. 58.)

The corporation books and records reflect a debit of \$5,890 to taxpayer's personal account on September 30, 1947. The personal records maintained by taxpayer reflect a cash receipt of \$5,890 from the corporation on September 12, 1947. (R. 59.)²

² No explanation was made by the Tax Court as to the disbursements by checks made by the corporation to taxpayer and his wife on March 21, 1947, in the amount of \$550; on June 30, 1947, in the amount of \$2.94; on June 30, 1947, in the amount of \$408.54; and on December 5, 1947, in the amount of \$2,292.36. (R. 59.)

As to the \$7,305.22 of debits made to the personal account of taxpayer in 1947, and the \$1,410.04 of debits made to the personal account of his wife, the books and records of the corporation reflect the following debits which are not reflected on the personal records maintained by taxpayer (R. 60-61):

4/30/47	General Journal entry. To transfer advances to officers to proper accounts.....	\$ 350.00
4/30/47	G. J. entry. Charge back unauthorized salaries paid to executives in December.....	\$1,499.50
4/30/47	G. J. entry. To charge Mr. Fihe for items in equipment account covering Mr. Fihe's filing cabinets for patents and so forth.....	\$ 563.47
4/30/47	G. J. entry. To charge personal accounts for excess payments on taxes withheld.....	\$ 86.34
4/30/47	G. J. entry. To charge owners of building for mortgage and interest on same paid by the corporation...	\$ 256.25
4/30/47	G. J. entry. Interest on officers life insurance loans, paid by the company, charged back to the appropriate officers.....	\$ 61.58
4/30/47	G. J. entry. To charge portion of traveling expenses to respective officers.....	\$ 705.96
4/30/47	No explanation.....	\$1,199.28
4/30/47	To adjust salaries upon which tax has been paid and not deducted.....	\$ 3.50
4/30/47	Cash disbursement.....	\$ 2.94
9/17/47	G. J. entry. To charge interest on insurance loans to officers concerned.....	\$ 34.04
9/30/47	G. J. entry. To correct distribution of check No. 8737 charged to Workmen's Compensation Insurance in error. Insurance agent states that this does not cover a company policy.....	\$ 250.00
12/5/47	Check issued to Mr. Fihe. Explanation of "royalties" crossed out and no explanation given.....	\$2,292.36
Total.....		\$7,305.22

The books and records of the corporation reflect the following debits to the personal account of taxpayer's wife in 1947 which are not reflected in her personal records (R. 61):

3/21/47	Check payable to Mrs. Fihe.....	\$ 550.00
4/30/47	G. J. entry. To adjust salaries upon which tax has been paid and not deducted.....	\$ 1.75
4/30/47	G. J. entry. To charge back unauthorized salaries paid to executives in December.....	\$ 449.75
6/30/47	Check payable to Mrs. Fihe.....	\$ 408.54
Total.....		\$1,410.04

With the exception of an entry reflecting the payment of taxpayer's income tax by the partnership, the

books and records of taxpayer and his wife for 1947 reflect income only for items which were deposited in their bank account. (R. 61.) Thus, amounts which might constitute income were not reflected in their books and records unless received by them in the form of checks, cash or notes. Even checks or cash receipts were not recorded as income unless such amounts were deposited in their bank accounts; and salary payments received by taxpayer and deposited by him were accounted for only in net amounts. i.e., after withholdings.

The Commissioner determined from the corporation's books and records (see R. 62) that some \$25,920 was paid or credited to taxpayer as salary, or \$5,295 more than was reported as income by taxpayer and his wife in their joint return for 1947, some \$14,000 (less withholding) of salary having been disbursed to taxpayer by check and some \$10,706.20 having been credited to his personal account. Additionally, the Commissioner determined that the corporation's books disclosed that \$7,145.33 of net credits were made to taxpayer's personal account reflecting royalty payments,³ and hence income, and that \$600 was credited as rents to the personal accounts of taxpayer and his wife. Thus, the Commissioner determined that taxpayers had received or had unfettered command of \$33,665.33 for 1947, or at least \$10,056.57 more than they reported as taxable income from the corporation on their 1947 joint return. (R. 55-61.)

For the following year, 1948, taxpayer and his wife reported \$1,200 of salary received from the corpora-

³ Apparently taxpayer reported royalty payments of \$2,983.76 as salary from the corporation.

tion. The W-2 form attached to taxpayer's 1948 return reflected total wages of \$2,061.90. (Ex. E.) The corporate books and records reflect that taxpayer received salary, net after withholding tax, in 1948 in the form of corporate checks as follows (R. 60):

1/2/48.....	\$327.10	(\$72.90 withheld as taxes)
1/9/48.....	\$327.10	(\$72.90 withheld as taxes)
1/16/48.....	\$327.10	(\$72.90 withheld as taxes)
1/31/48.....	\$861.90	

Taxpayers reported as income the first three checks but not the fourth check for \$861.90. The Commissioner determined that they had understated their 1948 income from the corporation by \$861.90. (R. 24, 64-65.)

The Tax Court sustained the Commissioner's determination that taxpayers had received from the corporation taxable income of \$10,056.57 for 1947 and \$861.90 for 1948 which they did not report. (R. 61-65.)

Issue No. 3

In December, 1947, taxpayers gave an option to the corporation whereby they agreed to sell to the corporation their capital stock, their interest in patents used by the corporation and their interest in certain improved realty. Taxpayers received a payment of \$1,000 for the option on December 13, 1947. (R. 65).

The improved realty involved in this transaction was real estate distributed to the individual partners upon dissolution of the partnership. It was conveyed to the corporation in 1948. The cost of the improved realty distributed to the four partners in September, 1946, was \$11,991.32. (R. 66.)

Taxpayer received his interest in the patents transferred to the corporation in exchange for his legal services in obtaining the patents. (R. 66.)

The assets and liabilities of the partnership, with the exception of the improved realty, were transferred to the corporation in exchange for capital stock. The capital accounts of the individual partners as of the date of the transfer of the partnership assets and liabilities to the corporation were as follows (R. 66-67):

H. H. Holly.....	\$8,174.57
Agnes Holly.....	8,174.57
Albert J. Fihe.....	8,174.57
Elizabeth M. Fihe.....	8,174.57
Total.....	<u>\$32,698.28</u>

At the time of the transfer, 200 shares of capital stock were issued by the corporation in the total amount of \$20,000 and paid in surplus was credited in the amount of \$12,698.28. Liabilities of the partnership to taxpayers in the total amount of \$8,122.78 were assumed by the corporation. (R. 67.)

In January, 1948, the corporation exercised the option and paid to taxpayers \$24,000 by check. In addition, the corporation gave to taxpayers two notes in the total principal amount of \$70,000, secured by a chattel mortgage on the corporate machinery and equipment. Further, a credit was entered to taxpayer's personal account on the corporate books in the amount of \$5,000 which settled a debit balance for that amount in his personal account. (R. 66.)

Commencing February 29, 1948, payments were made to taxpayers on the notes and mortgage in the amount of \$1,750 per month plus interest. These payments continued until the entire amount was paid. Taxpayers received payments on principal totalling \$17,500 in 1948. (R. 66.)

Taxpayers reported \$41,500 as the amount realized on the sale of their interests to the corporation and a

basis for such interests of \$27,624.36. (R. 67.) The \$41,500 sales price was apparently computed by adding the \$24,000 payment to the total of \$17,500 of monthly payments received in 1948, without recording the \$1,000 option payment received in December, 1947, or the \$5,000 credit to taxpayer's account.

Taxpayers computed on a separate schedule D the amount reported as net capital gain in their 1948 return but did not file the schedule of the return. Taxpayers, in computing the net capital gain reported on their 1948 return, deducted losses incurred in the sale of a personal residence and the sale of personal furniture and fixtures. The Commissioner disallowed the losses from the sales of the personal residence and of the furniture and fixtures. (R. 67.)

The Commissioner determined that taxpayers realized \$100,000 in 1948 from the sale of their interests to the corporation, as follows (R. 67-68):

Option payment (made in December, 1947).....	\$ 1,000
Cash payment (made in January, 1948).....	24,000
Credit to personal account of A. J. Fihe.....	5,000 ⁴
Face amount of notes and mortgage.....	70,000
	<hr/>
	\$100,000

Taxpayer asserted that he had a basis for the stock of \$27,624.36 upon the ground that he had advanced from \$36,000 to \$50,000 to the partnership and that these advances should be taken into consideration in computing his basis in the stock. (R. 70.) The Commissioner did not include such claimed advancements in his determination of basis, but determined a basis

⁴ The books and records of the corporation reflect this credit as of January 31, 1948, under the entry "To record purchase of patent rights, capital stock and land and buildings from A. J. and E. M. Fihe under option agreement dated 12/13/47." (R. 105, Appendix B, *infra*.)

for the stock of \$20,595.37, computed as follows (R. 68):

Basis of Patents.....		0
Basis of Stock.....	\$16,349.14	
Basis of Real Estate:		
Cost.....	\$11,991.32	
Less: Depreciation (as adjusted by respondent).....	3,498.86	
	<u>\$ 8,492.46</u>	
Petitioners' share thereof (50% of \$8,492.46).....		4,246.23
		<u>\$20,595.37</u>

Additionally, taxpayers attempted to prorate the capital gain over the years 1948 and 1949 upon the grounds that they were entitled to report on the installment basis and that the notes were non-negotiable and had no fair market value. The Commissioner rejected this upon the grounds that the initial payments received in 1948 exceeded 30 per cent of the total sales price, so that taxpayers could not use the installment method of reporting the income, and that there was no evidence establishing that the notes had no fair market value. (R. 70-71.)

The Tax Court sustained the Commissioner's determination of capital gain. (R. 68-72.)

Issue No. 4

The Tax Court found that in 1940 a revenue agent admonished taxpayer to keep more accurate books and records and that for the years involved taxpayer kept incomplete books and records, which did not reflect the taxable income of himself and his wife. The Commissioner assessed a 5 per cent addition to tax for negligence for the years 1946, 1947, and 1948. (R. 72.) The Tax Court sustained the imposition of these additions. (R. 72-73.)

SUMMARY OF ARGUMENT

The issues raised by taxpayers on appeal are factual, as taxpayers concede. Consequently, the question before this Court is whether the Tax Court's conclusions are clearly erroneous. The record reveals that the Tax Court in arriving at its findings of fact carefully examined all of the evidence produced at the hearing, that it had the opportunity of judging the credibility of taxpayers' testimony, and that its findings are supported by substantial evidence. Accordingly, we submit that the Tax Court's determination that there were deficiencies in taxpayers' incomes for the years 1946 through 1949, and that part of the deficiencies for the years 1946, 1947 and 1948, was due to negligence, should not be disturbed on appeal.

A. For the years 1946 through 1949 taxpayers claimed large amounts of business and personal deductions. The Commissioner disallowed part of the claimed amounts, on the grounds that deductions for some of the claimed expenditures were expressly prohibited by the 1939 Code, that others were for personal rather than for business purposes, that in some instances the same item was deducted twice by taxpayer, and that taxpayer failed to substantiate his right to deductions for the amounts claimed for other classes of items. The Tax Court upheld the Commissioner's action and taxpayers do not even attempt to show, by argument or evidence as distinguished from broad, unsubstantiated assertions, that any of the claimed deductions were allowable.

B. For 1947 and 1948 the Commissioner determined that taxpayers failed to report as income all of the amounts received by them as such from the corpor-

ation. During this period taxpayer and his wife were president and treasurer of the corporation. Taxpayer was in charge of the corporation's books and records, and taxpayer and his wife could draw checks on the corporation provided such checks were countersigned by either of the Hollys.

It was determined, from a detailed audit of the corporation's books and records, and particularly from the personal accounts of taxpayers in the corporate books, that some \$25,920 was paid or credited to taxpayer's account as salary in 1947, that credits were entered in his account for \$7,145.33 as patent installment payments and that credits of \$600 as rent were entered in his account and that of his wife, for a total of \$33,665.33, or \$10,056.57 more than taxpayers reported in their incomes as having been received from the corporation in 1947. These obligations of the corporation to taxpayers were discharged either by the payment of checks to taxpayers or by debit entries reflecting payment to others of taxpayers' debts, or by cancellation by the corporation of debts owed to it by taxpayers. Taxpayers reported in their incomes only those amounts paid to them by checks which they deposited.

For 1948 the corporation paid a salary to taxpayer of \$2,061.90 and sent to him a Form W-2 listing this amount as total wages. Taxpayer, however, reported a salary received from the corporation of only \$1,200 and omitted the last payment of \$861.90.

The record therefore fully supports the Tax Court's findings that taxpayers understated their incomes received from the corporation for 1947 and 1948.

C. The Commissioner determined that taxpayers understated the long-term net capital gain received by

them in 1948 from the sale of their interests in the corporation. The record supports the Commissioner's determination and the Tax Court's findings as to taxpayers' adjusted basis in patents, stock and real estate sold by them. Taxpayers' contention that they should have a higher adjusted basis than determined by the Commissioner appears to depend primarily on their self-serving unsupported testimony that they previously had advanced between \$30,000 to \$50,000 to the corporation. Taxpayers failed to substantiate this contention, and the record clearly supports the Tax Court's refusal to place any credence in it.

The record also supports the Commissioner's determination and the Tax Court's findings as to the amount realized from the sale. The discrepancies between the Commissioner's determination and taxpayer's figures result from the fact that taxpayers failed to include a \$1,000 option payment and a \$5,000 credit made by the corporation to taxpayer's personal account, and from the fact that the Commissioner included in his determination of sales price for 1948 the \$70,000 face amount of notes and mortgage received by taxpayers in that year, whereas taxpayers included only \$17,500 of installment payments on the notes received during that year.

Taxpayers contend that they did not include the face amount of the note in the sales price because the notes were non-negotiable and that they and the chattel mortgage securing them were worthless. However, the record supports the Tax Court's findings that the notes had value equal to their face amount. The notes were given by the corporation in satisfaction of an obligation to pay a fixed amount; the notes were secured and bore

interest; no evidence was introduced to show that the value of the chattel mortgage was less than the face amount of the note, or that the property subject to the mortgage was subject to foreclosure and quick sale for an amount less than the face amount of the notes, or that the notes were subject to conditions affecting their payment. In fact, as the Tax Court found, the notes were paid strictly according to their tenor in a comparatively short time. Accordingly, the Tax Court did not err in upholding the Commissioner's determination of value and in holding that taxpayers failed to meet their burden of proving affirmatively that the notes had a fair market value less than their face amount.

Since taxpayers received at least \$41,500 in cash during 1948 they cannot report their payments under the installment method permitted by Section 44(b) of the 1939 Code, for these initial payments exceed 30 per centum of the selling price.

D. In contrast to the assessment of fraud penalties, the Commissioner does not have the burden of proving negligence. Instead, the burden rests upon a taxpayer to overcome the presumptive correctness of the Commissioner's determination. The record in this case amply supports the Commissioner's determination and the Tax Court's findings that part of the deficiencies for 1946 through 1948 was due to negligence. Taxpayer has been a practicing attorney for many years and appears to have had considerable business ~~expense~~. In 1940 he was admonished by a revenue agent to keep more accurate books for his law practice and for any business with which he might be associated. Nevertheless, for 1946 through 1948 he claimed many deductions for items which were patently not deductible, he took

duplicate deductions for the same item, he failed to disclose the true nature of many of the claimed deductions, and he failed to include in his income amounts paid or credited to his account and made available for his use by the corporation, or even the full amount of salary paid to him by the corporation which was listed in the W-2 form given to him by the corporation and which he attached to his 1948 return.

ARGUMENT

The Tax Court Was Correct in Upholding the Commissioner's Determination That There Were Deficiencies in Taxpayers' Reported Incomes for 1946, 1947, and 1948, and That at Least Part of These Deficiencies Was Due to Negligence, So That Taxpayers Were Liable for the 5% Addition to Tax for Each of These Years under Section 293(a) of the Internal Revenue Code of 1939

The four issues involved in this appeal—(A) whether taxpayer understated his business income for the years 1946 through 1949 by claiming excessive itemized deductions and by understating business receipts; (B) whether taxpayers understated income received by them from the Holly Corporation for 1947 through 1948; (C) whether taxpayers understated the amount of long-term capital gain realized by them in 1948 upon the sale of their interests in the corporation; and (D) whether any part of the deficiencies asserted to be owing for the years 1946, 1947, and 1948 was due to negligence on the part of taxpayers—are “almost all strictly factual”, as taxpayers concede in their brief (p. 8).⁵

Taxpayers' main argument upon appeal consists of assertions that the Commissioner acted arbitrarily in assessing deficiencies and negligence penalties against

⁵ Taxpayers refer in their brief to a 1950 carry-back loss to 1948 (Br. 9, 19) but no such issue is involved in the case.

them and that taxpayers did not receive the amounts of income attributed to them by the Commissioner. (See Br. 19, 21, 22, 23-24.) These assertions are without merit. The record clearly shows that the Commissioner made a very thorough audit of taxpayer's records and of the books and records of the corporation before determining that there were deficiencies in taxpayers' incomes and that at least part of these deficiencies resulted from taxpayers' negligence. Similarly, the record reveals that the Tax Court carefully examined all the evidence in making its findings of fact and concluded that there was no basis, evidentiary or otherwise, for any of taxpayer's claims. (R. 52-55.)

The sole question on appeal, therefore, is whether the Tax Court's ultimate conclusions on these factual issues are clearly erroneous. In that connection it should be noted that such conclusions were based in part upon the Tax Court's appraisal of the testimony of taxpayer and his wife, who made self-serving statements without any substantiation. Thus, upon review the standard fixed by Rule 52(a) of the Federal Rules of Civil Procedure is applicable, namely that "due regard shall be given to the opportunity of the trial court to judge the credibility of the witnesses."⁶ The Tax Court's factual conclusions are therefore plainly

⁶ See Section 7482(a) of the Internal Revenue Code of 1954 (26 U.S.C. 1952 ed., Supp. II, Sec. 7482); *United States v. Oregon Med. Soc.*, 343 U.S. 325, 331-332; *United States v. Real Estate Boards*, 339 U.S. 485, 495-496; *United States v. Yellow Cab Co.*, 338 U.S. 338, 341-342; *Walling v. General Industries Co.*, 330 U.S. 545, 550; *Grace Bros. v. Commissioner*, 173 F. 2d 170, 173-174 (C.A. 9th); *Cohn v. Commissioner*, 226 F. 2d 22 (C.A. 9th); *Golden Construction Co. v. Commissioner*,¹ 228 F. 2d 637, 638 (C.A. 10); *Coates v. Commissioner*, 234 F. 2d 459, 462-463 (C.A. 8th); *Wis. Memorial Park Co. v. Commissioner* (C.A. 7th), decided May 16, 1958 (1 A.F.T.R. 2d 58-716).

entitled to finality. *United States v. Gypsum Co.*, 333 U.S. 364, 394-395, rehearing denied, 333 U.S. 869. "Here, the decision below was consistent with findings which on the evidence were well within the province of the trier" of the facts. *Chesbro v. Commissioner*, 225 F. 2d 674 (C.A. 2d), certiorari denied, 350 U.S. 995. The Tax Court was not obliged to believe the self-serving testimony of taxpayer and his wife whether or not it was contradicted or where it was patently unconvincing. Neither was the Tax Court bound to accept their testimony "when there are facts which even indirectly may give rise to inferences contradicting the witness" as here. *Cohan v. Commissioner*, 148 F. 2d 336, 337 (C.A. 2d); *Greenfeld v. Commissioner*, 165 F. 2d 318, 319-320. (C.A. 4th).

A. The Tax Court was correct in upholding the Commissioner's determination that taxpayer understated his business income from 1946 through 1949 by claiming excessive itemized deductions

The first issue involves the business income taxpayer derived from his practice of law in the years 1946 through 1949 and from the manufacture of fishing equipment in 1948 and 1949. The Commissioner's determination that taxpayer had understated his net income from these sources resulted principally from the disallowance of certain claimed expenses, either totally or in part. Part of the deficiency also resulted from an understatement of business receipts during these years. Taxpayer does not appear to contest these latter amounts on appeal.

As is shown in the Commissioner's ninety-day letters (R. 8-11, 20-29) and the Tax Court's findings of fact (R. 49-52), taxpayer claimed a wide variety of item-

ized business and personal deductions. Of the items in controversy for 1946, taxpayer claimed \$10,484.07 as business expenses. The Commissioner allowed \$7,946.60 of the claimed amount and disallowed \$2,537.47. For 1947 taxpayer claimed \$11,193.79 as business expenses. The Commissioner allowed \$6,590.84 and disallowed \$4,602.95. Also for 1947 taxpayer claimed at least \$8,129.03 of personal deductions. The Commissioner allowed \$1,753.65 and disallowed \$6,375.38. For 1948 taxpayer claimed \$35,761.55 as business expenses. The Commissioner allowed \$20,244.10 and disallowed \$15,522.45. Also for 1948 taxpayer claimed \$4,053.86 as personal deductions. Of these the Commissioner allowed \$1,027.04 and disallowed \$3,026.82. For 1949 taxpayer claimed over \$21,168.82 as business expenses. The Commissioner allowed \$10,295.22 and disallowed \$10,873.60. Also, for 1949 taxpayer claimed \$7,706.90 as personal deductions. Of these the Commissioner allowed \$47.51 and disallowed \$7,659.39. A brief review of some of these disallowed items reveals that the Tax Court did not err when it upheld the Commissioner's determinations.

Initially, it is appropriate to point out the well established rules governing the right of a taxpayer to claim deductions, namely, that their allowance is a matter of legislative grace which does not turn on general equitable considerations but depends upon the existence of a clear statutory provision as to which the burden of proof falls upon the taxpayer (*Deputy v. du Pont*, 308 U.S. 488, 493), that the Commissioner's disallowance of a deduction has the support of a presumption of correctness, and that the taxpayer has the additional burden of proving it to be wrong (*Welch v. Helvering*, 290 U.S. 111, 115).

The items which were disallowed here, either in whole or in part, fall into three separate categories. The first category consists of items the deductibility of which is expressly prohibited by the 1939 Code. For example, taxpayer sought to deduct federal income taxes paid by him. (Ex. D.) This is expressly prohibited by Section 23(c)(1)(A) of the 1939 Code (Appendix A, *infra*). For 1947 and 1948 taxpayer attempted to deduct all his medical expenses despite the limitation expressed in Section 23(x) of the 1939 Code (Appendix A, *infra*), that only amounts which exceed 5 per cent of a taxpayer's gross income may be deducted. Thus, the Commissioner was clearly correct in denying a deduction for amounts which did not exceed 5 per cent of taxpayer's gross income in each of the years 1947 and 1948.

The second category of disallowed deductions consists of items which would not be deductible under Section 24 of the 1939 Code (Appendix A. *infra*) if they were made for personal rather than business reasons and were not otherwise deductible under some provision of Section 23. For example, taxpayer testified that in 1947 the \$2,600 claimed as a business deduction for legal expenses was paid to assist Holly, his partner in defending himself against criminal charges because (R. 206) "Harry had a family * * * and I really hated to see my partner go to the penitentiary, so I offered to pay his legal fee which amounted to \$2,600.00 * * *." Although, as the Tax Court states (R. 53-54), this "testimony evidence a charitable motive, it does not establish the basis for a business deduction." *Friedman v. Delaney*, 171 F. 2d 269 (C.A. 1st), certiorari denied, 336 U.S. 936.

Taxpayer also claimed such items as the cost of new suits as advertising expense, testifying (R. 245) "If I do not look pretty prosperous, I do not get the patent business", and "Yes, I think it is perfectly good advertising and the only way a lawyer can advertise." Taxpayer claimed the loss on the sale of furniture in Chicago and claimed the cost of moving personal furniture and possessions from Chicago to Los Angeles as a business expense. (R. 167.) These are clearly personal, non-deductible expenditures.

Taxpayer also claimed deductions for travel expenses of his business, the costs incurred in maintaining his family in a hotel upon his move to Los Angeles and before his new home was established (R. 245), and the cost of driving his automobile to and from work (R. 245-246). Clearly these expenses also are personal and not deductible, and are not incurred "in carrying on" a business under Section 23(a)(1) of the 1939 Code (Appendix A, *infra*). *Commissioner v. Flowers*, 326 U.S. 465; *York v. Commissioner*, 160 F. 2d 385 (C.A. D.C.); *United States v. Woodall* (C.A. 10th), decided May 6, 1958 (1 A.F.T.R. 2d 58-1771); *Caragan v. Commissioner*, 197 F. 2d 246, 249-250 (C.A. 2d); Section 29.23(a)-15(b), Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939.

The third category of deductions claimed by taxpayer and disallowed by the Commissioner consists of items which are normally deductible. In the present case, however, the Commissioner denied some of the claimed deductions, either in whole or in part, upon the ground that taxpayer had failed to substantiate the claimed amounts or that the same items were deducted twice in the same year by taxpayer.

For example, in 1948 taxpayer claimed a loss for personal property—furniture—which was claimed to have been damaged in transit from Chicago to Los Angeles and for a valuable ring and wallet claimed to have been lost in transit. (R. 212, 257.) The sole evidence in support of this deduction is taxpayer's testimony (R. 212):

In that connection, when we moved our furniture out here [to California], it was certainly in a wreck somewhere, because when we got it, most of it was almost irreparably damaged—a beautiful marble top table that we had was just broken into smithereens—some of the fine furniture looked as if it had been dragged through the mud. The upholstery was torn and almost beyond repair. Some valuable lamps were gone completely. My wife had a very valuable ring somewhere in that furniture and it never did get here. May I say that at one time I saw my wife weeping very bitterly when she saw that furniture.

For all that appears in the record, these losses (hardly casualty losses) may have been covered by insurance or claims may have been made against the movers. The Tax Court correctly denied the claimed deduction for the following reason (R. 55):

This record falls far short of furnishing a basis for allowing the casualty loss. There was no evidence regarding the loss of cash in a wallet. No fair market value of the damaged furniture has been proved and no basis for the property has been shown. The claimed loss is disallowed for lack of proof. See *Helvering v. Owens*, 305 U.S. 468.

Duplicated items of claimed deductions included two deductions in 1949 for a \$3,909.95 interest payment which taxpayer himself conceded (R. 17, 209, 246) was deducted both as a business expense and as a personal expense. Taxpayer also conceded (R. 17, 246-247) that in 1949 he deducted \$3,511.44 for taxes twice on his return.

As we have already indicated, the only arguments offered by taxpayers to support the claimed deductions are general statements to the effect that the Commissioner's disallowances (and inferentially the Tax Court's findings) are "unfair", "ridiculous" and "indicative of the antagonistic, belligerent and entirely unreasonable attitude of one or more of the agents or their superiors." (Br. 19, 20, 21, 23-24.) Such statements are unwarranted and certainly do not substantiate his right to the claimed deductions. *Deputy v. du Pont, supra*. Thus, the Tax Court was clearly correct in holding that taxpayer failed to meet his burden of proof and in sustaining the Commissioner's determination that taxpayer had understated his business income for the years 1946 through 1949.

B. *The Tax Court was correct in upholding the Commissioner's determination that taxpayers understated income received by them from the Holly Corporation in 1947 and 1948*

During 1947 and part of 1948 taxpayer and his wife were president and treasurer, respectively, of the Holly Corporation. Taxpayer was in charge of the corporation's books and records. Both taxpayer and his wife had authority to draw checks on the corporation provided such checks were countersigned by either Mr. or Mrs. Holly.

The revenue agent conducted an investigation of the corporation's books. A deposition was taken of Frank H. Wiscons, who has been comptroller of the corporation since 1948 and during 1946 and 1947 was its purchasing agent. (R. 81-154.) Wiscons testified as to the entries in the taxpayers' personal accounts in the corporation's books for the period October 1, 1946, through January 31, 1948. The Commissioner determined from these entries that taxpayers had understated their incomes from the corporation by \$10,056.57 in 1947 and \$861.90 in 1948. The Tax Court sustained the Commissioner's determinations. (R. 55-65.)

It is clear that where corporate funds are diverted to the personal use of a large or controlling stockholder or funds are made subject to his unfettered control without substantial limitation or restriction as to time, manner or condition of payment, such funds constitute income to him. *Lash v. Commissioner*, 245 F. 2d 20 (C.A. 1st); *Ross v. Commissioner*, 169 F. 2d 483 (C.A. 1st). See *Davis v. United States*, 226 F. 2d 331, 334-335 (C.A. 6th), certiorari denied, 350 U.S. 965; *Dawkins v. Commissioner*, 238 F. 2d 174 (C.A. 8th); *Chesbro v. Commissioner*, 21 T.C. 123, affirmed *per curiam*, 225 F. 2d 674 (C.A. 2d), certiorari denied, 350 U.S. 995; *Burns v. Commissioner*, 31 F. 2d 399 (C.A. 5th), certiorari denied, 280 U.S. 564. Such is the case here.

The corporation's books and records disclose that \$25,920 was paid or credited as salary to taxpayer in 1947. According to these books some \$14,000, less withholding, of this amount was disbursed to taxpayer by check and \$10,706.20 was credited to his personal account on April 30, 1947. (R. 86-89.) The corporation's books further disclose that \$7,145.33, consisting of a credit of \$6,227.21 on September 30, 1947 (R. 101-

102), and a credit of \$918.12 on December 20, 1947 (R. 103), was made to the personal account of taxpayer as patent installment payments⁷ and that \$600, consisting of two credits of \$140 each on April 30, 1947 (R. 93, 112-113), two credits of \$100 each on September 30, 1947 (R. 102, 133), and two credits of \$60 each on December 30, 1947 (R. 103, 113-114), were made to the personal accounts of taxpayer and his wife. These items amount to \$33,665.33, or \$10,056.57 more than taxpayers reported as receiving from the corporation on their joint return for 1947.

Taxpayers contend, among other things (Br. 11), that alleged changes in the corporation's books "showed quite a bit of money either charged to the Fihe's account or showing money that was presumably paid to them and which they did not get [R. 211]." It should be noted that taxpayer does not contest the fact that he received the \$14,000 of salary. His contention appears to be only that he did not receive any of the amounts for salary, patent payments and rent which were credited to his personal account with the corporation. This contention is refuted by an examination of this account.⁸

The personal accounts of taxpayers on the corporation books are liability accounts. Accordingly, credits to these accounts reflect liabilities of the corporation to taxpayers and debits reflect payments of such liabilities. These debits were in addition to the \$14,000 in salary already mentioned, which was paid to him directly and not run through the liability account.

⁷ This \$7,145.33 figure does not include a credit of \$5,123.03 made to taxpayer's personal account on April 30, 1947, which was reversed as of the same date. (R. 93, 97-98.)

⁸ An analysis is set forth in Appendix B, *infra*.

The personal accounts reflect liabilities of the corporation to taxpayer for additional salary in the amount of \$10,706.20; for patent installments, \$7,145.33; for rent, \$300; and for rent to taxpayer's wife, \$300. These liabilities were discharged in 1947 by payments by check or in cash and by debits to taxpayers' personal accounts. The fact that the liabilities were discharged in 1947 makes the amounts thereof taxable income in that year to taxpayers, who reported their income on the cash basis.

During 1947 payments in cash to taxpayer amounted to \$2.94 (R. 99); those by check amounted to \$14,049.41 and were as follows:

Record Page	Date of Book Entry	Amount
91.....	1/31/47	\$1,000.00
91.....	3/31/47	800.00
92.....	4/30/47	700.00
92.....	4/30/47	700.00
92.....	4/30/47	2,325.00
98-99.....	5/31/47	2,600.00
99.....	6/30/47	3,632.05
102.....	12/30/47	2,292.36
		<hr/> \$14,049.41

During 1947 payments by check and debits to taxpayer's wife's personal account amount to \$2,058.54, as follows:

Record Page	Date of Book Entry	Amount
109.....	1/31/47	\$ 800.00
109.....	3/31/47	550.00
110.....	4/30/47	300.00
112-113.....	6/30/47	408.54
		<hr/> \$ 2,058.54

Taxpayer's personal account for 1947 also shows payment of some \$13,899.92 by debits⁹ whereby the corpo-

⁹ The \$5,123.03 reversing entry relating to patent payments of April 30, 1947 (R. 93, 97-98), is not included in this amount.

ration's obligations to him were discharged. His wife's personal account for 1947 lists some \$707.75 of debits (in addition to the previously mentioned payments by check) in discharge of the corporation's liability to her.

The nature of the debits in the personal account of the taxpayer is reflected by the following: Of the debit entries made on April 30, 1947, the entry of \$350 (R. 94-95) reveals that that amount was paid to taxpayer as salary; the entry of \$563.47 (R. 95) indicates that the corporation paid for filing cabinets belonging to taxpayer; the entry of \$256.25 (R. 96) indicates that the corporation paid mortgage and interest payments on taxpayer's property; the entry of \$61.58 (R. 96-97) indicates that the corporation paid interest on taxpayer's life insurance; the entry of \$705.96 (R. 97) indicates that the corporation paid taxpayer's travel expenses; the entry of \$34.04 of September 30, 1947 (R. 100), indicates that the company paid interest on taxpayer's insurance loans; the entry of \$5,890 (R. 100-101) indicates that taxpayer had been making withdrawals of cash from the corporation; the entry of \$250 (R. 101) indicates that the company had paid for taxpayer's policy; etc.

The debits in the personal account of the taxpayer's wife for 1947 of \$707.75 (in addition to the check payments) include an entry of April 30, 1947, of \$449.75 (R. 110) for salary which had been paid but not charged to her; an entry of \$1.75 (R. 110-111) to adjust social security taxes paid for her benefit, and an entry of \$256.25 (R. 96, 111) which indicates that the corporation had made mortgage and interest payments on a building owned by her.

To recapitulate, the Commissioner has charged taxpayers with the receipt in 1947 of \$18,451.53 in income over and above the approximately \$14,000 paid to taxpayer as salary without being run through his personal account, and the receipt of that additional income in the amount of \$18,451.53 is amply shown by the books of the corporation as having been paid in cash (\$2.94), checks issued directly to taxpayers (\$16,110.89), and payments to others for taxpayers' benefit together with payments or withdrawals in cash (\$8,111.30), as shown by the above examples. The latter amount does not even include all of the items that might have been charged to taxpayers as income.

Further, taxpayer's personal account reveals (Appendix B, *infra*) that on January 1, 1947, the corporation was indebted to taxpayer for \$2,161.49, whereas on January 1, 1948, taxpayer was indebted to the corporation for \$6,915.07; and that on January 1, 1947, the corporation was indebted to taxpayer's wife for \$1,711.29, whereas on January 1, 1948, it was indebted to her for only \$120. This also indicates that taxpayers drew upon the corporation for income in 1947.

For 1948, the following year, the corporation's payroll ledger charged taxpayer with the following salary (R. 115-116):

1/2/48....	\$400.	(\$72.90 withheld as taxes, net \$327.10)
1/9/48....	\$400.	(\$72.90 withheld as taxes, net \$327.10)
1/16/48....	\$400.	(\$72.90 withheld as taxes, net \$327.10)
1/31/48....	\$861.90	(no deductions)

For 1948 taxpayer reported he received a salary of \$1,200 from the corporation, yet he attached to his return a Form W-2 showing receipt of total wages of \$2,061.90 and withholding tax of \$206.70. (Ex. E.) As the Tax Court correctly pointed out (R. 64-65):

It is the difference between the \$2,061.90 shown by Form W-2 and the reported \$1,200 which the Commissioner has added to petitioner's taxable 1948 income. We find no adequate explanation whatever in the record for petitioner's faulty reporting and have found that the difference of \$861.20 should have been reported as taxable income in accordance with the Commissioner's determination.

Taxpayers apparently seek to refute the necessary conclusion from the 1947 book entries (Br. 15, R. 222) that the corporation's books "were not in their present condition when he had charge of them," and "that the accountants, Barrow, Wade & Guthrie, performed some really unusual feats of bookkeeping * * *." We submit that the Tax Court correctly disposed of this contention when it held (R. 64) :

We are of the opinion that this testimony in no way destroys the probative value of the corporate books. The accountants who caused the corrections to be made were the same accountants employed by petitioner himself to audit the records at a time when he himself was in control of the corporation. Their competency is in no way impugned by petitioner's testimony and we have no reason for discounting the accuracy of entries as shown on the books.

Further, the accuracy of these entries is evident even from the evidence submitted by taxpayer. Whatever discrepancies may appear to exist between the entries in the corporation's books and the personal records maintained by taxpayer (Ex. 11), they are conceded by taxpayer to have resulted from the fact that (R. 197,

234-236) he recorded only cash receipts which were deposited in his and his wife's bank account. Thus, taxpayers' records did not reflect for 1947 any amounts which were not paid directly to them and were deposited by them. For example, the debit entry of September 30, 1947, of \$5,890 (R. 100-101), which is explained on the corporate books as "to correct errors in cash detail record," is not reflected in taxpayer's records. Taxpayer testified (R. 201) that this represented the proceeds from the sale of furniture and for patent work, admitting that he received a check for \$5,890 from the corporation. The corporation's bill of sale for furniture, however, was dated January 19, 1948, and was in the amount of \$890.67. (Ex. 12.) A credit entry was made to taxpayer's personal account in the corporation's books on January 31, 1948, in the amount of \$890.67 with the explanation "to record purchase of certain furniture under purchase agreement, dated January 19, 1948." (R. 104; Appendix B, *infra*.) In the face of this evidence it appears that taxpayer is mistaken as to the \$5,890 entry, that the sale of furniture actually took place in 1948 and not in 1947, that the sales price of the furniture was \$890.67 and not \$5,890.67, and that taxpayer did not lose any \$5,000 on this transaction, as he alleges. (Br. 14.) It also appears clear that the \$5,890 entry in 1947 reflected cash disbursements to him in that year, and that the corporation's entries were correct.

Taxpayer's records (Ex. 11) also do not reflect any entry for the \$2,600 which he concedes was paid by the corporation to the attorney who defended Holly and which was charged to taxpayer's personal account. (R. 238; Br. 12.) This amount is reflected on the cor-

poration's books as a debit entry for a check payment to taxpayer's personal account of \$2,600 on May 31, 1947, and is explained as a loan from the corporation. (R. 98-99; Appendix B, *infra*). Taxpayer admits (R. 238-239) that he never included this amount in his income, although he claimed it as a deduction in his 1947 return. As the Tax Court correctly held (R. 63-64):

The failure to include this item is typical of petitioner's explanations on this score. He excused it by saying "I certainly haven't got the money. In fact I spent the money. It is gone." This, of course, is no excuse for failing to include amounts as income which came into petitioner's control at a time when the corporation ostensibly could pay them and when the petitioner was in control of the corporate books and for aught that appears of record could have taken down payment directly.

Accordingly, we submit that the Tax Court's decision on this issue is not clearly erroneous and should be sustained by this Court.

C. *The Tax Court was correct in sustaining the Commissioner's determination that taxpayers had understated their long-term capital net gain in 1948 from the sale of their interests in the corporation.*

In January, 1948, taxpayers sold their interests in the corporation pursuant to an option agreement previously executed by them in December, 1947. At issue is the amount of the long-term capital net gain which they received in 1948, and whether this gain can be reported on the installment basis under Section 44(b) of the 1939 Code (Appendix A, *infra*). Taxpayers re-

ported a basis of \$27,624.36 and a sales price of \$41,500, or a long-term net capital gain of \$13,875.64. The Tax Court upheld the Commissioner's determination of a basis of \$20,595.37 and a sales price of \$100,000, or a long-term net capital gain of \$79,504.63. (R. 65-72.)

The Commissioner's adjusted basis of \$20,595.37 was computed as follows (R. 68):

Basis of Patents.....		0
Basis of Stock.....		\$16,349.14
Basis of Real Estate: Cost.....	\$11,991.32	
Less: Depreciation (as adjusted by respondent).....	3,498.86	
	<hr/>	
	\$ 8,492.46	
Petitioners' share thereof (50% of \$8,492.46).....		4,246.23
		<hr/>
		\$20,595.37

An examination of the record supports such a basis as will be seen.

Taxpayer testified (R. 248) that he had acquired his half interest in the patents in exchange for performing services in securing the patents. He did not show that he had ever placed any value upon the patents which he had included in his income. Accordingly, both the Commissioner and the Tax Court were correct in giving a zero basis to the patents.

The \$16,349.14 basis of the stock was determined from the fact that the capital accounts of the four partners as of the date of the transfer of the partnership assets and liabilities to the corporation was \$32,698.28, and at the time of the transfer the corporation credited its capital stock account with \$20,000 and its paid in surplus account with \$12,698.28. (R. 66-67.) Taxpayers do not contest this amount. (Br. 15-16.)

There does not appear to be any controversy as to the \$8,492.46 total basis of the real estate. Taxpayer testified (R. 240-241) that this property was distributed to

the individual partners by the partnership before the partnership was formed, and was then sold by the partners around September 30, 1946, to the corporation for \$11,991.32. Thus, the record supports the basis for the sale property used by the Commissioner and accepted by the Tax Court.

Taxpayers' contention that they had a basis of \$27,-624.36 appears to rest primarily upon their self-serving assertion (Br. 15; R. 172) that they advanced between \$30,000 to \$50,000 to the corporation. No proof was submitted by taxpayer to substantiate this contention except five notes of the partnership totalling \$12,724.36. (Exs. 3, 4, 5, 6, 10.) The Tax Court correctly disposed of this contention as follows (R. 70):

To prove error in the Commissioner's determination, petitioners rely on their self-serving oral testimony to the effect that they advanced from \$36,000 to \$50,000 to the partnership and that these advances should be taken into consideration in computing basis. To corroborate this testimony a series of notes of the partnership to petitioner aggregating some \$12,724.36 dated in 1940 and 1942 were introduced in evidence. One of the notes bore endorsements showing credits of \$6,-211.29. This evidence is inadequate to overcome the correctness of the Commissioner's determination of basis which is supported by other evidence of record. Even if we accept at face value petitioners' oral testimony that they made the claimed advances to the partnership it still seems certain that substantial sums were repaid to them which would reduce the cost of their stock. Their testimony as to these transactions is fragmentary at

best. They have not come forward with evidence which would establish error in the Commissioner's determination of basis, which is sustained.

Support for the Tax Court's holding—that, even if taxpayers made advances to the partnership, substantial amounts thereof were repaid by the corporation—also comes from the subscription agreement and minutes of the corporation's first board meeting and the corporation's books. The subscription agreement and minutes (Exs. 2 and 8) show that the corporation assumed the outstanding liabilities of the partnership (which would include any unpaid loans from taxpayers) in exchange for capital stock of \$20,000 and paid in surplus (which was \$12,698). The corporation's records (R. 85; Appendix B, *infra*) disclose some \$8,122.78 of liabilities owing to taxpayers which were assumed by the corporation on October 1, 1946, and which were later paid off by the corporation. Thus, it appears that all outstanding liabilities were otherwise taken into account when the corporation was formed, and taxpayers should not be entitled to increase their basis for any amounts allegedly advanced by them in prior years to the partnership.

Section 111(b) of the 1939 Code (Appendix A, *infra*) provides as follows:

The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

The Commissioner determined that taxpayers realized \$100,000 from the sale of their interests in the corporation, computed as follows (R. 67-68):

Option payment (made in December 1947).....	\$ 1,000
Cash payment (made in January 1948).....	24,000
Credit to personal account of A. J. Fihe.....	5,000
Face amount of notes and mortgage.....	70,000
	<hr/>
	\$100,000

Taxpayers compute a sales price of \$41,500 by adding the \$24,000 cash payment to the total monthly payments on the notes in 1948 of \$17,500.

There is no doubt but that taxpayer received the \$1,000 option payment (R. 188, Br. 16) although he did not include it in his computation of the sales price. Although this payment was made in December, 1947, when the option was entered into, the \$1,000 was properly includible in the determination of net capital gain for 1948 when the option was exercised and the property was sold. *Aiken v. Commissioner*, 35 F. 2d 620, 624 (C.A. 8th), affirmed on other grounds, 282 U.S. 277.

No controversy exists as to the \$24,000 cash payment made in January, 1948. Also, it is clear that the \$5,000 credit made by the corporation to taxpayer's personal account on January 31, 1948, is properly includible in determining the sale price. Taxpayer was overdrawn in his account with the corporation, i.e., he owed the corporation \$5,000 in January, 1948. The corporation credited this amount to his personal account, with the explanation that this amount was "to record purchase of patent rights, capital stock, and land and buildings from Mr. A. J. Fihe and Elizabeth M. Fihe under option agreement dated December 13, 1947." (R. 104-105; Appendix B, *infra*.) By this action on the part of the corporation taxpayer was relieved from paying \$5,000 to the corporation when his account was closed. Accordingly, this \$5,000 amount is includible in determining his net capital gains (*Winkelman v.*

Commissioner, decided February 20, 1943 (1943 P-H T.C. Memorandum Decisions, par. 43,092)), and taxpayers' contention (Br. 16) that it should not be included because it was never paid to him is without merit.

Thus, the main question is whether the Tax Court was correct in holding that the \$70,000 face amount of the note secured by a chattel mortgage is includible in the sale price, or whether taxpayers are correct in including only the \$17,500 of monthly note payments made in 1948. Taxpayers appear to contend (Br. 16) that the notes had no value (and therefore did not constitute consideration received for the sale property, cf. *Westover v. Smith*, 173 F. 2d 90 (C.A. 9th)) because they were non-negotiable and the chattel mortgage was itself worthless. But non-negotiability is not the same as non-transferability and, as the Tax Court held (R. 71-72), taxpayers have failed to show that the notes lacked value. The question whether they had a fair market value is of course one of fact. *Perry v. Commissioner*, 152 F. 2d 183, 186 (C.A. 8th).

As the Tax Court stated (R. 71), the burden was upon taxpayers to show not only that the secured notes were not worth their face amount but that the notes either had no fair market value or what that value was (see *Owen v. United States*, 8 F. Supp. 707 (C. Cls.)). The record indicates that the notes had value equal to their face amount, since they were given by the corporation in satisfaction of an obligation to pay a fixed amount, were secured, and bore interest. Taxpayers did not introduce the notes,¹⁰ the chattel mortgage or

¹⁰ The taxpayer testified (R. 225) that the notes "are paid and probably destroyed."

any other evidence to show that the value of the chattel mortgage was less than the face amount of the notes, that the property subject to the mortgage was not subject to foreclosure and was not readily saleable for the face amount of the notes, or that the notes were subject to conditions affecting their payment, or that the notes were not transferrable. As a matter of fact, as the Tax Court stated (R. 72), the notes "were paid strictly according to their tenor in a comparatively short time." Thus, the Tax Court did not err in upholding the Commissioner's determination that the face amount of the notes was the proper amount to be used in the computation of taxpayers' long term net capital gains. *Whitlow v. Commissioner*, 82 F. 2d 569 (C. A. 8th).

Taxpayers are not entitled to use the installment method of reporting the gain from the sale of their interests to the corporation. Section 44(b) of the 1939 Code permits a taxpayer to return income on the installment basis if "the initial payments do not exceed 30 per centum of the selling price * * *." The section defines the term "initial payments" to mean "the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made." The statutory provision is clear that the entire payments received in the taxable period are includible in the "initial payments" and that the "selling price" means the total amount involved in the sale and includes cash and other property received by the seller. *Waukesha Malleable Iron Co. v. Commissioner*, 67 F. 2d 368 (C.A. 7th). Here the sale took place in 1948. During 1948 taxpayers received a \$24,000 cash payment

in January, plus monthly payments during the balance of the year in the amount of \$17,500, amounting to "initial payments" of \$41,500. This amount exceeds 30 per centum of the "selling price" of \$100,000.¹¹

Moreover, a taxpayer who desires to use the installment basis of accounting must make an election to do so not later than when he files his return; he cannot make such an election "after expiration of the time within which return is to be made * * *." *Pacific National Co. v. Welch*, 304 U.S. 191; *United States v. Kaplan*, 304 U.S. 195; *Daley v. United States*, 243 F. 2d 466 (C.A. 9th); *Jacobs v. Commissioner*, 224 F. 2d 412, 414 (C.A. 9th). Here, the record does not show that taxpayers ever made such an election. Taxpayer failed to attach any Schedule D to his 1948 return (Ex. E) or otherwise submit sufficient facts to indicate that he had elected to report his capital gains on the installment basis.

Finally, there is no warrant in the statute for permitting a taxpayer, in computing net capital gain upon the sale of a capital asset, to deduct all kinds of expenses which are unrelated to such asset, as taxpayer here seeks to do. (Br. 17-18.) Further, there is even less warrant for permitting such a computation where all of the "expenses" sought to be deducted were disallowed for such reasons as that they were personal expenditures or were unsubstantiated (see Part B

¹¹ If this Court should determine that only part of taxpayers' long-term net capital gain should be reported in 1948, then part of the gain would also be reported in 1949. Under such circumstances we submit that the case should be remanded to the Tax Court, to adjust taxpayer's 1949 net income and to reduce the net operating loss carry-back from 1949 to 1947, which would result in an increased deficiency for 1947. The year 1949 is in issue in this case.

of brief, *supra*). What taxpayers are attempting to do is to trade off their acceptance of the Commissioner's determination of long-term net capital gain for 1948 if this Court would now allow all of the previously disallowed alleged business expenses for 1948 plus the disallowed amount of taxpayers' contributions for that year. The answer, as the Tax Court stated (R. 69), is that: "It is almost axiomatic that such losses are not allowable."

D. *The Tax Court was correct in sustaining the Commissioner's determination that part of the deficiencies for 1946, 1947 and 1948 was due to taxpayers' negligence*

Section 293(a) of the 1949 Code (Appendix A, *infra*) provides, in part, that "If any part of any deficiency is due to negligence, or intentional disregard of rules and regulations but without intent to defraud, 5 per centum of the total amount of the deficiency (in addition to such deficiency) shall be assessed * * *." In contrast to the imposition of fraud penalties, the Commissioner does not have the burden of proving negligence. Instead, similar to the determination of a deficiency, the burden is upon a taxpayer to overcome the presumptive correctness of the Commissioner's determination as to negligence. *Boynton v. Pedrick*, 228 F. 2d 745 (C.A. 2d), certiorari denied, 351 U.S. 938, rehearing denied, 351 U.S. 990; *Young v. Commissioner*, 208 F. 2d 795 (C.A. 3d), affirming decision of April 10, 1953 (1953 P-H T.C. Memorandum Decisions, par. 53,120). Here the record clearly justifies the Commissioner's imposition of negligence penalties, as the Tax Court found. (R. 72-73.)

Taxpayer has been a practicing attorney for many years and appears to have had considerable business experience. In view of his education and experience taxpayer cannot claim ignorance as any excuse for his multifold disregard of the 1939 Internal Revenue Code.

The Tax Court's finding that part of the deficiencies was due to negligence is clearly supported by the record. First, as we have shown in Part B, *supra*, taxpayer claimed many deductions which were patently not deductible, such as federal income taxes, cost of personal clothing, the expenses of moving his family and personal belongings and of maintaining his family in a hotel, etc. Taxpayer also duplicated several deductions for interest and taxes. Further, many of the claimed deductions were for exaggerated amounts. These actions reflect a negligent attitude on the part of taxpayer. *Beus v. Commissioner*, 28 T. C. 1133.

Second, taxpayer did not disclose sufficient facts to reflect the basis of deductions he claimed. For example, the cost of personal clothing was claimed as a business advertising expense; claimed federal income taxes were not segregated from allowable tax deductions; the cost of moving his family was claimed as freight and travel expenses of his business; and losses incurred in 1948 on the sale of his personal furniture and fixtures were utilized to reduce his long-term net capital gains on the sale of his interests to the corporation, but no Schedule D was attached to the 1948 return (Ex. E), or any other information was appended to the return to explain these deductions. These actions also reflect a negligent attitude by tax-

payer. *Pohlen v. Commissioner*, 165 F. 2d 258 (C.A. 5th).

Third, as taxpayer admits (R. 233), a revenue agent had advised him in 1940 to keep more accurate books with respect to his law practice and in connection with any business with which he might be associated. Apparently taxpayer did not heed this admonition for, as the Tax Court found (R. 72-73), the books and records kept by taxpayer from 1946 through 1949 "were incomplete and did not properly and accurately reflect the taxable income of [taxpayers]." For example, taxpayer was president of the corporation and in charge of its books in 1947. Either he or his wife had to sign or countersign every check disbursed by the corporation. He personally hired an accounting firm to audit the corporation's books and records. He must have checked the entries made by the corporation to his personal account in the corporation's books which charged him and his wife with income and which reflected payment and discharge by the corporation of its obligations to him. Nevertheless he failed to reflect in his personal records or report as income substantial amounts received by him from the corporation which reflected income entries. Also, for 1948, taxpayer had received a Form W-2 withholding statement from the corporation prior to the filing of his return which listed salary paid to him of \$2,061.90 and tax withheld of \$206.70. Nevertheless he reported receiving a salary of only \$1,200 from the corporation, omitting \$861.90, yet taking credit for withholding on this latter amount. These actions also clearly reflect a negligent attitude on his part. *Evans v. Commissioner*, 235 F. 2d 586 (C.A. 8th), certiorari denied, 352 U.S. 909; *Hurley v. Commissioner*, 22 T.C. 1256, affirmed on other issues,

233 F. 2d 177 (C.A. 6th); *Board v. Commissioner*, 51 F. 2d 73 (C.A. 6th), certiorari denied, 284 U.S. 658; *Little v. Helvering*, 75 F. 2d 436 (C.A. 8th); *Sutor v. Commissioner*, 17 T.C. 64.

Taxpayers contend that the Tax Court erred in upholding the Commissioner's assessment of negligence penalties against them on the grounds that their "1946 returns were prepared by a firm of certified public accounts" (Br. 8), that their 1947 returns "reflected absolute concurrence with the Corporation income tax return for the year 1947" (Br. 9), and that for all years they kept complete books and records (Br. 22-23). Taxpayer has not shown that he made full disclosure of all the facts to the accountant in the preparation of his 1946 return. Accordingly, his reliance upon an accountant is misplaced. The contention that his books and records were complete or were in conformity with the corporation's return is clearly refuted by the record. Accordingly, we submit that taxpayers have failed to show that the Tax Court erred in sustaining the Commissioner's imposition of negligence penalties.

CONCLUSION

The decisions of the Tax Court are correct and should be affirmed by this Court.

Respectfully submitted,

CHARLES K. RICE,
Assistant Attorney General.

LEE A. JACKSON,
MELVA M. GRANEY,
KARL SCHMEIDLER,

Attorneys,
Department of Justice,
Washington 25, D. C.

JUNE, 1958.

APPENDIX A

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) [As amended by Sec. 121 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. * * *

* * * * *

(c) [As amended by Sec. 202 of the Internal Revenue Act of 1941, c. 412, 55 Stat. 687] *Taxes Generally.*—

(1) *Allowance in general.*—Taxes paid or accrued within the taxable year, except—

(A) Federal income taxes;

* * * * *

(e) *Losses By Individuals*.—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise——

- (1) if incurred in trade or business; or
- (2) if incurred in any transaction entered into for profit, though not connected with the trade or business; or
- (3) of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft. No loss shall be allowed as a deduction under this paragraph if at the time of the filing of the return such loss has been claimed as a deduction for estate tax purposes in the estate tax return.

* * * * *

(1) *Depreciation*.—[As amended by Sec. 121(c) of the Internal Revenue Act of 1942, *supra*.] A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)——

- (1) of property used in the trade or business, or
- (2) of property held for the production of income. * * *

* * * * *

(x) [As added by Sec. 127(a) of the Revenue Act of 1942, *supra*, and amended by Sec. 8(c) of the Individual Income Tax Act of 1944, c. 210, 58 Stat. 231; and Sec. 304 of the Revenue Act of 1948, c. 168, 62 Stat. 110] *Medical, Dental, Etc., Expenses*.—Expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent specified in section 25(b)(3), to the extent that such expenses exceed 5 per centum of the adjusted gross income.

The deduction shall not be in excess of \$1,250 multiplied by the number of exemptions allowed under section 25(b) for the taxable year (exclusive of exemptions allowed under section 25(b)(1)(B) or (C), with a maximum deduction of \$2,500, except that the maximum deduction shall be \$5,000 in the case of a joint return of husband and wife under section 51(b). * * *

(26 U.S.C. 1952 ed., Sec. 23.)

SEC. 24. ITEMS NOT DEDUCTIBLE.

(a) *General Rule.*—In computing net income no deduction shall in any case be allowed in respect of—

(1) [As amended by Sec. 127(b) of the Revenue Act of 1942, *supra*] Personal, living, or family expenses except extraordinary medical expenses deductible under section 23(x);

* * * * *

(26 U.S.C. 1952 ed., Sec. 24.)

SEC. 44. INSTALLMENT BASIS.

* * * * *

(b) *Sales of Realty and Casual Sales of Personality.*—In the case (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding \$1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 30 per centum of the selling price (or, in case the sale or other disposition was in a taxable year beginning

prior to January 1, 1934, the percentage of the selling price prescribed in the law applicable to such year), the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. As used in this section the term "initial payments" means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

* * * * *

(26 U.S.C. 1952 ed., Sec. 44.)

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

* * * * *

(26 U.S.C. 1952 ed., Sec. 111.)

SEC. 293. ADDITIONS TO THE TAX IN CASE OF DEFICIENCY.

(a) *Negligence.*—If any part of any deficiency is due to negligence, or intentional disregard of rules and regulations but without intent to defraud, 5 per

centum of the total amount of the deficiency (in addition to such deficiency) shall be assessed, collected, and paid in the same manner as if it were a deficiency, except that the provisions of section 272(i), relating to the prorating of a deficiency, and of section 292, relating to interest on deficiencies, shall not be applicable.

* * * * *

(26 U.S.C. 1952 ed., Sec. 293.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.111-1. *Computation of Gain or Loss.*—Except as otherwise provided, the Internal Revenue Code regards as income or as loss sustained, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property which is received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value. The general method of computing such gain or loss is prescribed by section 111, which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 113(b) and sections 29.113(b)(1)-1 to 29.113(b)(3)-2, inclusive (i.e., the cost or other basis provided by section 113(a), adjusted for receipts, expenditures, losses, allowances, and other items chargeable against and applicable to such cost or other basis). The amount which remains after the

adjusted basis has been restored to the taxpayer constitutes the realized gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained in the amount of the insufficiency. The basis may be different depending upon whether gain or loss is being computed.

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APPENDIX B

ANALYSIS OF PERSONAL ACCOUNT—A. J. FIHE
PER DEPOSITION OF FRANK H. WISCONS

Record Page	Book Entry Date	Entry	Dr.	Cr.
85	10/1/46	Liability account due.....	\$	\$ 4,661.49
90	11/30/46	Cash disbursement book check 11/1—\$500 and check 11/25/ 46—\$2,000 to Albert J. Fihe..	\$ 2,500.00	
	12/31/46	Balance.....	2,161.49	
			<u>\$ 4,661.49</u>	<u>\$ 4,661.49</u>
	1/1/47	Balance.....		\$ 2,161.49
91	1/31/47	Check 1/10/47 to A. J. Fihe....	\$ 1,000.00	
91	3/31/47	Check 3/17/47 to A. J. Fihe....	800.00	
91	4/30/47	Loan from corporation.....	3,000.00	
92	" " "	Check.....	700.00	
92	" " "	Check.....	700.00	
92	" " "	Check.....	2,325.00	
92	" " "	Proceeds of insurance loans ad- vanced to corporation.....		724.18
87-88	" " "	Executive salaries—accrued but not paid for seven months ended 4/30/47.....		10,706.20
93	" " "	Rent on building for seven months ended 4/30/47.....		140.00
93	" " "	To set up patent installment pay- ments due for seven months ended April 30, 1947.....		5,123.03
94	" " "	No explanation per deposition...	1,199.28	
110-111	" " "	Adjust OAB Tax.....	3.50	
94-95	" " "	To transfer advances to officers to proper accounts.....	350.00	
95	" " "	To charge back unauthorized sal- aries paid to executives in De- cember.....	1,499.50	
95	" " "	Charge Mr. Fihe for items in equipment account.....	563.47	
95-96	" " "	To charge personal accounts for excess payments on taxes with- held.....	86.34	
96	" " "	To charge owners of building for mortgage and interest on same paid by corporation.....	256.25	
96-97	" " "	Interest on officers life insurance loans paid by corporation....	61.58	
97	" " "	To change portion of travelling expenses to respective officers..	705.96	
97-98	" " "	To cancel journal entry relative to patent payments contract for purchase not signed.....	5,123.03	

Record Page	Book Entry Date	Entry	Dr.	Dr.
98-99	5/31/47	Check to A. J. Fihe 5/13/47.....	\$ 2,600.00	
99	6/30/47	Cash.....	2.94	
99	6/30/47	Check.....	3,632.05	
100	9/30/47	Interest on insurance loans to officers concerned.....	34.04	
100-101	" " "	To correct errors in cash detail record.....	5,890.00	
101	" " "	To correct distribution of check No. 8737 charged to Work- men's Comp. Ins. in error on 11/14/46. Insurance agent states that this does not cover a company policy.....	250.00	
101-102	" " "	Patent installment due under contractor for year ended 9/30/47.....		\$ 6,227.21
102		To charge rent on building at \$80 per month for five months ended 9/30/47.....		100.00
102	12/30/47	{ Check 2/5/47 to A. J. Fihe.....	2,292.36	
		{ Royalties scratched out		
103	" " "	To record minimum on royalties.		918.12
103	" " "	To accrue rents under lease arrangement.....		60.00
	12/31/47	Balance.....		6,915.07
			<u>\$33,075.30</u>	<u>\$33,075.30</u>
	1/1/48	Balance.....	\$ 6,915.07	
104	1/31/48	To reverse audit in J.E. #12 dated 4/30/47 applicable to OAB. This was deducted from employees later.....		\$ 42.50
104	" " "	To record purchase of certain furniture under purchase agree- ment dated 1/19/48.....		890.67
104-105	" " "	To close balance in Fihe's accounts charged to A. J. Fihe's salary.....		981.90
105	" " "	To record purchase of patent rights, capital stock, and land and buildings from Mr. A. J. Fihe and Elizabeth M. Fihe under option agreement dated 12/13/47.....		5,000.00
105	2/1/48	Balance.....	-0-	-0-
			<u>\$ 6,915.07</u>	<u>\$ 6,915.07</u>

ANALYSIS OF PERSONAL ACCOUNT—ELIZABETH FIHE PER DEPOSITION OF FRANK H. WISCONS

Record Page	Book Entry Date	Entry	Dr.	Cr.
85,105	10/1/46	Credit balance in account.....		\$ 3,461.29
105-107	10/31/46	Checks to various individuals charged to Mrs. Fihe's account \$	300.00	
107-108	11/30/46	Checks to various individuals charged to Mrs. Fihe's account	750.00	
108	" " "	Check 11/18/46 to Mrs. Fihe....	700.00	
	" " "	Balance.....	1,711.29	
			<u>\$3,461.29</u>	<u>\$3,461.29</u>
	1/1/47	Balance.....		\$1,711.29
109	1/31/47	Check 1/10/47 to Mrs. Fihe.....	\$ 800.00	
109	3/31/47	Check 3/21/47 to Mrs. Fihe.....	550.00	
110	4/30/47	Check 3/21/47 to Mr. Fihe....	300.00	
110	" " "	To adjust salaries upon which tax has been paid and not deducted	449.75	
110-111	" " "	Adjust OAB tax.....	1.75	
96,111	" " "	To charge owners of building for mortgage and interest on same paid by corporation.....	256.25	
111-112	" " "	To transfer advances to officers to proper account.....		875.00
111-112	" " "	Rent on building for seven months ended 4/30/47.....		140.00
112-113	6/30/47	Check 6/20/47 to Mrs. Fihe.....	408.54	
113	9/30/47	Rent on building.....		100.00
113-114	12/30/47	Rent on building.....		60.00
	12/31/47	Balance.....	120.00	
			<u>\$2,886.29</u>	<u>\$2,886.29</u>
	1/1/48	Balance.....		\$ 120.00
114	1/31/48	To close balance of Mrs. A. J. Fihe's account charged to A. J. Fihe's salary.....	\$ 120.00	
	2/1/48	Balance.....	-0-	-0-
			<u>\$ 120.00</u>	<u>\$ 120.00</u>

